

September 2008 Market Review

Given the dynamic nature of the markets at present we have also included a short update of activity since month end.

What is going on with markets?

Global markets are currently in a dislocated state. We have experienced large falls in the last 3 weeks that are not based on any fundamental or logical valuation basis.

These market conditions have been driven by an increasing liquidity trap as the global banking system has ground to a halt. In the face of not being able to access bank credit investors, are selling down shares to repay current and looming debt obligations.

Sharemarkets are the easiest markets where people can still access liquidity at present and there is little consideration being given to the value at which they are selling these shares.

We now have a 'frozen' global banking system as banks are not lending to each other. Distrust and fear is high and this has ground lending to halt despite increasingly desperate attempts by central banks and Governments to get it going again.

What happens now?

Simply put, we need a circuit breaker and a big one. The banks have to be forced to lend to each other, lend to their clients and to stop hoarding their cash.

To break the liquidity (and solvency) trap, global Government intervention is now the only way to unlock these credit markets and get funds moving again. Key global Governments need to act immediately (particularly the US) in concert and aggressively.

On Friday night the G7 countries announced their latest and most co-ordinated effort to address the problem. They outlined a five point plan where the members have stated they will work together to re-build stability in the global banking system. The plan was very light on detail but included direct investment in banks (the UK solution), pumping more liquidity into the system via their central banks, protecting depositors accounts, protecting banks and stabilizing markets.

It was widely rumoured in markets on Friday night the G7 would announce a package to effectively guarantee the interbank lending market and remove counterparty risk but this has not happened at the time of writing.

Over the weekend we also saw the Reserve Banks of Australia and New Zealand move to guarantee retail deposits with eligible banks and non-bank deposit taking institutions. The RBA and RBNZ have also agreed to fund the Australian & NZ banks own mortgage assets which takes the pressure off them from having to source funds for this from offshore markets.

The World Economy Outlook

The economic outlook has been weaker for sometime as is a normal part of any cycle. It was also likely to be recessionary in some parts of the world and positive in others. We would like to think this is still the central scenario (and should be) but with far weaker growth than we were expecting earlier in year. The outlook is for growth about 3% for 2008-9 (way down from 5%+ the last few years) and then a pick up in growth into 2010.

We will work our way through this current situation, the world will keep turning and businesses and economies will keep operating though with lower growth. This is not like the Depression of the 1930s as the world is a vastly different place from those times and has the financial tools, global capital and concerted Government policy response to deal with it. There are also excess global savings and capital is and will be made available to keep economies ticking over.

Markets will capitulate and find their bottoms quickly if not already and we are likely to see significant rallies as investors gain confidence and move from cash positions to pick up significantly undervalued assets.

These rallies will happen well before we see the end of any economic recession. Typically markets rally hard 4-6 months before economies start to improve and high quality assets will recover first as bargain hunters move in.

A reminder that portfolios that hold high quality assets and are well diversified will survive these conditions but patience is required at present.

This quarter we have included a separate review on the approach we take to building client portfolios and managing portfolio risk. This is especially important for those that feel tempted to try and time the markets by getting out and then trying to get back in during these conditions.

Economic and Market Commentary

There is so much going on in financial markets at present and there is an enormous amount of commentary and hyperbole. We have focussed this report on the key issue of the frozen credit markets and the flow on effect.

Sharemarkets, property and commodity markets all fell dramatically in late September and have continued to do so up to the time of writing (12th October).

We are in an historical situation with regard to the speed and degree of market contraction for most assets, globally. This is a direct function of the retraction of credit and the unwinding of borrowed positions in assets where debt has to be repaid.

The initial sharp falls in late September were a direct response by investors fearing the global credit crunch had finally reached a point of seizure and that this would dramatically impact on global economic growth and create a global recession.

As the freeze in credit markets spills over into a retraction of credit that is available to consumers and businesses the risk to global growth is very real. For instance borrowing by U.S. consumers unexpectedly fell in August by the most since 1943. This is a combination of banks not lending and people not borrowing. Consumer spending after all is the biggest part of the US economy and will certainly impact US growth.

Since late September investor concern has moved beyond any reasonable concerns of a global slowdown to one of outright fear. Investors are now irrationally exiting shares (even excellent ones), property, commodities any fixed interest investments that are less than high quality, small country currencies and even weaker country sovereign bonds. Fear has presently replaced logic and fundamentals.

Volatility in share markets reached extreme levels with the VIX (Volatility Index) at an all time high since the index began in 1994.

Since the beginning of the year the S&P 500 index of US stocks is down – 38% (to its lowest levels since 2003) for its worst years performance since 1937 and the Dow is on course for its worst years performance since 1931 at the time of writing.

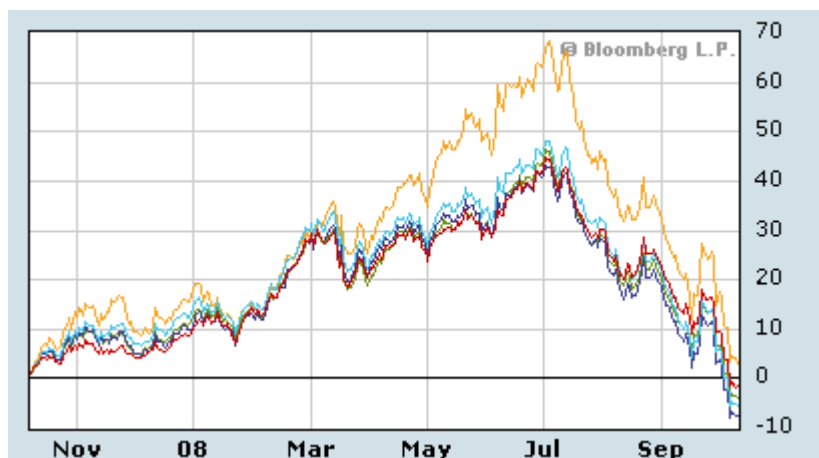
Some \$US30 trillion has been wiped of the value of world stocks in the past year with the Morgan Stanley Capital Index down -35%. Other sharemarkets have fallen further with several markets such as China, falling as much as 65% since October 2007.



Property prices have also continuing to fall. The Case Shiller Home Price Index for US property shows prices there down -16.3% year on year, UK property prices are down -12.4% this year, New Zealand down -8% year on year and prices elsewhere are falling.

Commodity prices have fallen sharply on the back of a sharply slower global growth outlook and puts fears of inflation firmly to the sidelines. Gold prices have recently rallied after falling as investors seek a safe haven.

Commodity Prices Collapse



Commodity Indexes to October 9th. Source: Bloomberg.

Oil prices have fallen to below \$85 per barrel and more than 42% from their highs and energy and resource companies subsequently fallen in value.

The flight to safety by investors has seen shorter maturity US Treasury Bills fall to historical lows and a sell down weaker currencies in favor of the USD.

Investors are also selling currencies and moving to USD and the YEN as perceived currencies places of safety. Weaker country currencies (like NZD) are being sold down.

We are simply seeing the most rapid rate of deleveraging (reduction in geared investment exposure) and reduction of asset prices in history. Markets are giving back the gains they made over the last few years in a matter of weeks and days.

Banks in particular are being forced to deleverage as they mark down their mortgages and mortgage securities exposures and seek to raise new capital and or merge or be nationalized through equity for debt buy-in programs. US banks have largely been through this dramatic process but European banks have been tardy. They are now paying the price and going through the same pain as the US.

A greater risk for Europe is their ability to keep their monetary union in place which will be at threat unless the EU and ECB can act decisively and in a united manner.

At present banks are barely lending to each other out of counter party risk concern...will they get their money back. As such they are hoarding their cash and increasingly relying on central bank funding for their liquidity. The banks for instance are paying a 4+% premium to that which the US treasury pays for borrowing 3 month money. This is the highest premium since Bloomberg began compiling the data in 1984.

Governments are accelerating their tactical and strategic policy responses to get in front of the action and stabilize financial markets.

What is being done to help?

A global policy response is now in full cry with all Governments working furiously to stabilise the markets.

Their responses are also becoming more co-ordinated and we have seen a recent simultaneous 0.5% global interest rate cut by the major reserve banks. We are also seeing actions that are more strategic in nature though daily tactical actions are also taking place.

The US being the first to be drawn in (and the root cause) has implemented a number of tactical responses including:

- ❖ Increasing the insurance levels on retail bank depositor's funds from \$100,000 to \$250,000. This is designed to prevent a run on banks.
- ❖ US Treasury has introduced a series of buy-back and loan programs to take risky securities of bank balance sheets.
- ❖ US Fed has and continues to provide liquidity and funding into the financial system to ease freezes.
- ❖ Direct tactical intervention by the US and State Federal Reserve Banks and US Treasury with nationalization of banks and insurers (Freddie Mac and Fannie Mae, AIG), facilitation of sales and mergers of banks and letting some fail in the process (to avoid moral hazard).
- ❖ The Emergency Economic Stabilization Act of 2008 was finally introduced after a week of political jockeying to provide Treasury the immediate capacity to start buying troubled securities (up to USD\$700bn).
- ❖ The Fed recently announced they will create a special fund to purchase commercial paper from banks in a bid to force open the flow of credit to the businesses. This is critical to keep businesses operating.

The key objective of all this activity is to unlock what are effectively frozen credit markets. Banks are currently hoarding their funds and not lending as they fear counter party risk. They need to start lending again to each other consumers and businesses. This flow of funds is at the heart of any normal functioning economy.

While these tactical activities continue to take place, strategically, there is also a lot of policy development going on behind the scenes. The US Federal Reserve, Treasury, Securities Commission and others are working on new regulatory policy including bringing investment bank activity under tighter US Fed control and forcing a far higher level of transparency in the operation of banks and the 'shadow' banking system that has emerged in over the last 10 years.

We also expect to see an introduction of mechanisms to prevent asset bubbles and excessive lending happening again.

Financial derivatives markets will be more heavily regulated and the Credit Default Swaps derivative market (that has everyone so worried) will be moved onto an exchange before year end to increase transparency of counterparty risk and pricing.

Clearly, the US banking system will never be the same again and we are in for a period of dramatic and continued intervention and regulation by Government.

Elsewhere around the Globe we are now seeing similar responses:

- ❖ Guarantees of deposits in UK, Ireland, Germany, France, Norway, Spain, Iceland, Korea, and elsewhere (not NZ or Australia...yet). All designed to stop a run on banks.
- ❖ Nationalisation of several banks, lending institutions and insurance companies that are considered system critical.
- ❖ Liquidity injection by central banks in most markets including Australia, Japan, US, UK, EC countries, Korea, and others.
- ❖ UK announced a GBP50bn capital package for banks needing more capital. The BOE takes a commercial position for the capital. Also \$250bn has been made available for banks to borrow should they require.

What are the positives now?

- ❖ The concerted, rapid and co-ordinated global Government policy response is unprecedented and needs to be. They are now acting faster and with more tools at their disposal than any other financial market crises in history.
- ❖ The world has not run out of money. Global savings as cash reserves are still rising. Sovereign Wealth Funds have an estimated \$USD 3.5 trillion in cash assets they can bring to bear. Private wealth in cash at banks around the world is also soaring as hoarding has taken place. Some of this cash will be re-deployed into property and business assets (shares) once the panic subsides.
- ❖ In the US, companies have historically low levels of gearing and some \$US620billion in cash to invest in their businesses. This will enable them to retain financial flexibility to quickly reallocate capital.

- ❖ Inflation is now a sideline issue. With global growth likely to be half what it was two years ago and falling commodity and oil prices inflation is no longer an issue that requires a monetary policy response. This opens the way for substantial interest rate cuts.
- ❖ Interest rates will be cut further and quickly. The Reserve Bank of Australia cut rates by 1% (largest cut since 1992) and we expect the RBNZ will cut rates a similar amount this month. The US will also cut rates by 0.5% and possibly more down to 1.5% and possibly 1%. Other countries are currently following suit. The cuts do many things including reducing the costs for mortgage borrowers, taking pressure of banks (as short term funding costs decline) and forcing depositors to consider alternative investments in the face of falling rates (such as a 9% dividend yield on Vector shares).
- ❖ Market exhaustion. The market has been declining for 12 months with intermittent periods of stability then further sales. The recent panic and all time volatility levels suggest a point of capitulation which needs to be reached before markets can re-build. We have been through a lot and the end of the mess is a lot closer. Trading volumes are generally very thin and investors are sitting on the sidelines and not participating.
- ❖ Markets have already weathered a massive reduction in price with assets in many markets now well undervalued on any sort of recovery outlook. Global (MSCI World Index) Price Earnings ratios (a broad measure of value) fell to 10.9x which is the cheapest since 1985. The S & P 500 price to book ratio is at its lowest since the 1980s. In the 1930s, PEs averaged 11 x. NZ shares are trading at an average of 12x.
- ❖ On the above basis, market valuations are at 20+yr lows and this is based on an expected weaker earnings growth outlook. The MSCI PE numbers are based on a 30% expected decline in earnings.
- ❖ As economies and companies earnings recover, good quality assets will look very cheap in hindsight.
- ❖ Like shares, property values have also fallen substantially in the US, UK and other markets have already taken a large hit in prices. While they may have further to fall, they are now representing reasonable value again we expect prices will begin to stabilize by the end of this quarter. The outlook in NZ remains very weak.
- ❖ The cost of oil and commodities have all fallen dramatically (some more than 60% with oil down 42%) reducing the cost of manufacturing and improving the prospects for better earnings despite lower global demand levels.
- ❖ In Asia, the financial system is in also in good shape having learned their lessons in the early 1990s in Japan and elsewhere in Asia during the 1998 Asian banking crises. They are well funded with strong balance sheets to support their economies and activities.

The Outlook

At present we are seeing a dislocation in markets. With no confidence and much fear market prices have gone down beyond any valuation fundamentals even assuming a period of very low global growth.

As asset prices fall the need to cover liabilities increases demanding further assets sales to cover these liquidity requirements.

The risk is that we have subsequently entered a vicious cycle or as the Americans call it a 'negative feedback loop' where frozen credit markets stall business and private consumption leading to poorer economic growth leading to higher unemployment, higher mortgage defaults and tighter lending conditions.

This cycle needs to be broken and quickly. Governments trying to act as a circuit breaker and are taking increasingly dramatic steps to achieve this and measures could include taking over the operations of key banks in certain economies to force them to lend money to stop the current hoarding that is going on.

Central banks are likely to reduce monetary policy as aggressively as they can while still retaining some policy room. We expect interest rates in NZ to move from the current 7.5% levels to as low as 5.5% and possibly lower than this over the next 12 months. US rates are likely to be reduced to 1% and substantial further cuts in Europe, UK and elsewhere are also likely.

These rate cuts will reduce borrowing costs and encourage cash back into higher earning risk assets such as property and shares.

The freeze in credit markets will have a negative impact on global growth. No longer is a 3.5% rate of growth likely. Recessions are likely currently underway (even if not in the data yet) in Japan, UK, Europe, US, Australia, NZ and other parts of the world).

China will also slow but still generate positive growth (estimates of 6-7% as will other parts of Asia, Middle East, Latin America, Eastern Europe and Africa. Compared to the size of the western nations their growth contributions will be positive but overshadowed and we expect total world growth next year to fall under 3% (the IMF defines a global recession when growth is less than 3%).

New Zealand

The RBNZ is responding to the crises but clearly thinks it has more time than it has. They have put in place temporary liquidity measures (accepting mortgage backed securities as collateral) but need to consider faster and deeper interest rate cuts as well as some guarantee on deposits.

We expect a series of sharp cuts from the Reserve Bank as inflationary concerns evaporate on falling house prices (-8% year on year), falling private consumption and household credit growth, collapses in commodity prices including oil (our commodity price indexes took another sharp fall being down 4.9% month on month for September driven by falling dairy prices) and rising unemployment and lower employment intentions all pointing to continued recessionary conditions well into 2009. On the inflationary front only wage demands remain a risk but these are not likely to be sustainable.

Interest rates at the time of writing are 7.5% (remember they were at 8.25%) and it is likely we will see further cuts in October and in December. Interest rates may be below 6% by the end of Q1 2009 and move as low as 5% in 2009 (or lower).

The sharply lower NZD against the US and Yen will provide some offset to lower dairy prices for some markets but our steep rise against the AUD will offset some of this benefit. As interest rates are cut the NZD should weaken against the AUD as well.

Our current account deficit has also deteriorated and is now running at 8.4% of GDP. This deterioration is a concern given the high cost and limited availability of overseas borrowing at present.

The pre-election Treasury fiscal update showed a sharp deterioration in our operating accounts with operating surpluses likely to be replaced with deficits putting financial pressure on any election promises and constraining incoming Government.

Based on current Treasury expectations and recent market turmoil we expect GDP growth for the calendar 2008 year will be negative at -0.4% to -0.5%. Looking to 2009 recessionary conditions are likely to remain in place for the first two quarters as terms of trade decline further on weaker commodity prices with some positive growth in the later half of 2009.